TRANSFER PRICING AND MULTINATIONAL FINANCIAL INSTITUTIONS: THE CASE FOR REPLACING ARM'S LENGTH PRICE WITH A UNITARY APPROACH

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Abstract

The international tax system, designed a century ago, has not kept pace with the modern multinational entity rendering it ineffective in taxing many modern businesses according to economic activity. One of those modern multinational entities is the multinational financial institution (MNFI). The recent global financial crisis provides a particularly relevant and significant example of the failure of the current system on a global scale. The modern MNFI is increasingly undertaking more globalised and complex trading operations. A primary reason for the globalisation of financial institutions is that they typically 'follow-the-customer' into jurisdictions where international capital and international investors are required. The International Monetary Fund (IMF) recently reported that from 1995-2009, foreign bank presence in developing countries grew by 122 per cent. The same study indicates that foreign banks have a 20 per cent market share in OECD countries and 50 per cent in emerging markets and developing countries. Hence, most significant is that fact that MNFIs are increasingly undertaking an intermediary role in developing economies where they are financing core business activities such as mining and tourism. IMF analysis also suggests that in the future, foreign bank expansion will be greatest in emerging economies. The difficulties for developing countries in applying current international tax rules, especially the current traditional transfer pricing regime, are particularly acute in relation to MNFIs, which are the biggest users of tax havens and offshore finance. This paper investigates whether a unitary taxation approach which reflects economic reality would more easily and effectively ensure that the profits of MNFIs are taxed in the jurisdictions which give rise to those profits.

It has previously been argued that the uniqueness of MNFIs results in a failure of the current system to accurately allocate profits and that unitary tax as an alternative could provide a sounder allocation model for international tax purposes. This paper goes a step further, and examines the practicalities of the implementation of unitary taxation for MNFIs in terms of the key components of such a regime, along with their their implications. This paper adopts a two-step approach in considering the implications of unitary taxation as a means of improved corporate tax coordination which requires international acceptance and agreement. First, the definitional issues of the unitary MNFI are examined and second, an appropriate allocation formula for this sector is investigated. To achieve this, the paper asks first, how the financial sector should be defined for the purposes of unitary taxation and what should constitute a unitary business for that sector and second, what is the 'best practice' model of an allocation formula for the purposes of the apportionment of the profits of the unitary business of a financial institution.

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